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Towards a sustainable and growth supportive FX policy in Ukraine

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Towards a sustainable and growth supportive FX policy in Ukraine

Executive Summary

From 2000 to 2008, the National Bank of Ukraine (NBU) pegged the Hryvnia to the US dollar. In the autumn 2008 the international financial crisis hit Ukraine and the currency was let to float, a move which implied a sizeable devaluation. During the course of 2009 the NBU allowed for some currency flexibility. However, since January 2010 the Hryvnia has been de facto fixed once again to the US dollar at a level of around 8.00 UAH/USD.

From January 2010 till mid-2011 the peg was held without significant turbulences. However, starting from mid-2011 problems appeared and from mid-2012 these problems intensified. By now, it is obvious that the peg does not represent a sustainable FX policy. Official FX reserves are dropping fast and have now reached the critical level of 3 months import coverage. But also the current account is deteriorating fast. In 2012, the current account deficit is heading towards 7.2% of GDP, at a time of relative low FDI and difficult access to international capital markets. The population reacts with heavy purchases of cash FX, thus further weakening the currency and making the situation even less sustainable.

On top, the current FX policy has a very negative impact on economic growth. In order to maintain the overvalued exchange rate, monetary policy is extremely restrictive and interest rates very high. At some stages, the benchmark 1-month Kiev prime surpassed 40%, while inflation is practically zero. High interest rates imply lower investment and are bad for short- and long-term economic growth. In short, the current FX system is not sustainable and is restricting economic growth. Thus, the question is no longer whether, but how to change the system.

Two changes need to be performed: the level of the exchange rate has to be adjusted and a new system has to be installed. Regarding the level, there is a sizeable, though not huge need for devaluation. In principle, a gradual devaluation could prevent some hardship for economic agents. However, the current low level of FX reserves does not allow for a gradual approach. Thus, the country needs a sudden devaluation. In order to ensure an orderly process and to anchor expectations for the future, the sudden devaluation needs to be accompanied by the establishment of a new system. On the one hand, the new system has to provide an anchor for monetary policy and expectations; on the other hand, it needs to secure enough flexibility for absorbing shocks.

Regarding the anchor, we propose the use of a currency basket consisting of US dollar, Euro and Russian Rouble, with each currency having the same weight (i.e. 1/3). This weighting broadly reflects Ukraine's trade patterns and is easy to understand. A currency basket is in our view preferable to a peg to the US dollar, especially because it reduces the negative effect of cross currency volatility between the major currencies. While the choice of a currency basket already increases flexibility, there is a need to ensure additional flexibility by setting a relatively wide band.

The new exchange rate system will help to restore macroeconomic stability and economic growth. At the same time, it will pave the way for the foreseen introduction of inflation targeting in the medium term. Higher exchange rate flexibility, especially towards single currencies such as the US dollar, will contribute to the development of institutions and instruments which are necessary for implementing inflation targeting in the future.

Finally, the new transitory exchange rate system should be part of an overall adjustment of macroeconomic policy, including a clear tightening of fiscal policy. The necessary adjustment of macroeconomic policy should be implemented in the context of a new IWF program; a move that will increase credibility and the likelihood of an orderly exit out of an unsustainable macroeconomic situation.

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1. Introduction

Currently, FX policy is making renewed headlines in Ukraine. Hardly a day passes by without news on this topic. A continuous drain of official FX reserves, persistent depreciation expectations and a new wave of administrative restrictions by the authorities to influence the FX market raise a number of urgent questions regarding the sustainability of the current policy stance. The objective of this paper is to analyse the current situation and make concrete proposals in terms of its reform.

The paper is structured as follows: In chapter 2 we will provide a description and an assessment of the current stance of FX policy in Ukraine, including its impact on economic growth. The following chapter 3 deals with concrete policy recommendations on how to reform FX policy. Chapter 4 provides an outlook and puts the need to change FX policy into a wider perspective of readjusting the overall macroeconomic policy mix in Ukraine.

2. FX policy in Ukraine: Description and Assessment

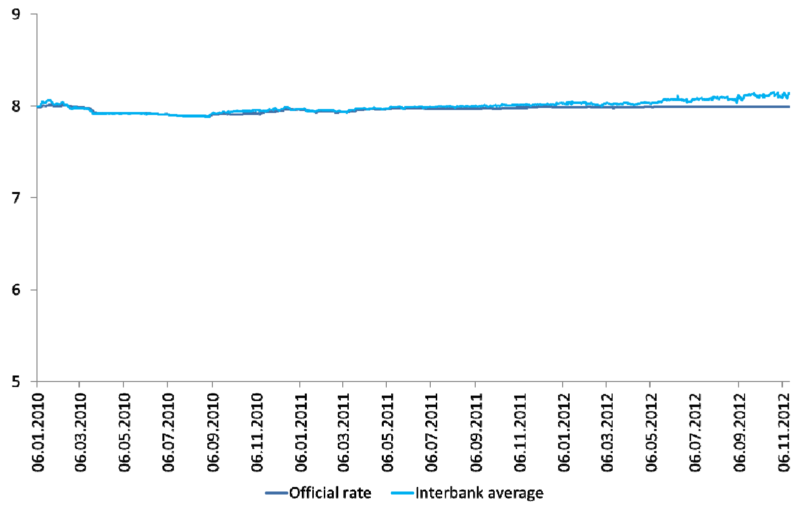
2.1 Current FX policy: De facto fixing to USD

The current de-jure classification of Ukraine's exchange rate arrangement by the IMF is a "transition to a free floating exchange rate". The de-facto classification by the IMF is a "stabilized arrangement against the dollar" since 1 March 2010, and reconfirmed in January 2011. The de-facto monetary policy framework is "an exchange rate anchor to the U.S. dollar" according to the Fund.

Indeed, the de-facto FX policy implemented by the National Bank of Ukraine is a tight peg of the Hryvnia to the US-Dollar. From Figure 1 below we can see that the exchange rate has been fixed at a level of currently 7.99 UAH/USD (official exchange rate), while the average NBU market rate is with currently 8.15 UAH/USD slightly higher.

Figure 1

Exchange rate UAH/USD



Source: NBU

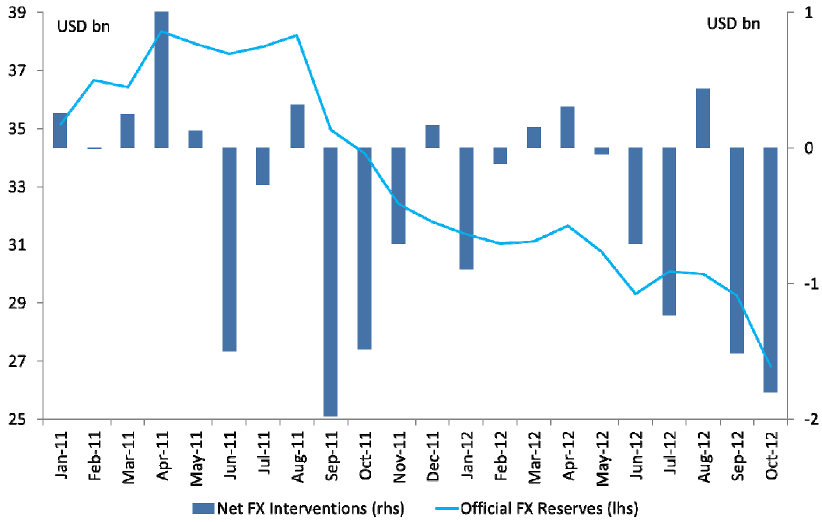
2.2 Assessment of current FX policy: Not sustainable

As Figure 1 shows, the NBU has been able to maintain the external value of the Hryvnia at a level of around 8.00 UAH/USD for some years now. However, there are clear signs that the national currency is overvalued and that the situation is not sustainable, i.e. the current level cannot be maintained for long. In the following, we will provide an overview of respective indicators that show persistent depreciation pressures.

One of the most important indicators is the development of official FX reserves, and the associated level of net interventions on the FX market (Figure 2).

Figure 2

Official FX reserves and net FX interventions



Source: NBU

The persistent pressure on FX reserves is remarkable, as the National Bank is forced to intervene on a continuing basis. FX reserves dropped from USD 38.2 bn in August 2011 to only USD 26.8 bn in October 2012, a drop of USD 11.4 bn. In September and October 2012, the National Bank spent more than USD 1.5 bn in interventions per month. At the same time, import coverage of reserves dropped to 3.1 months recently, after amounting to 5 months in August 2011.

In order to support the peg under adverse external conditions, the National Bank was forced to conduct a very tight monetary policy stance, as the following Figure 3 shows:

Figure 3

1-month Kievprime

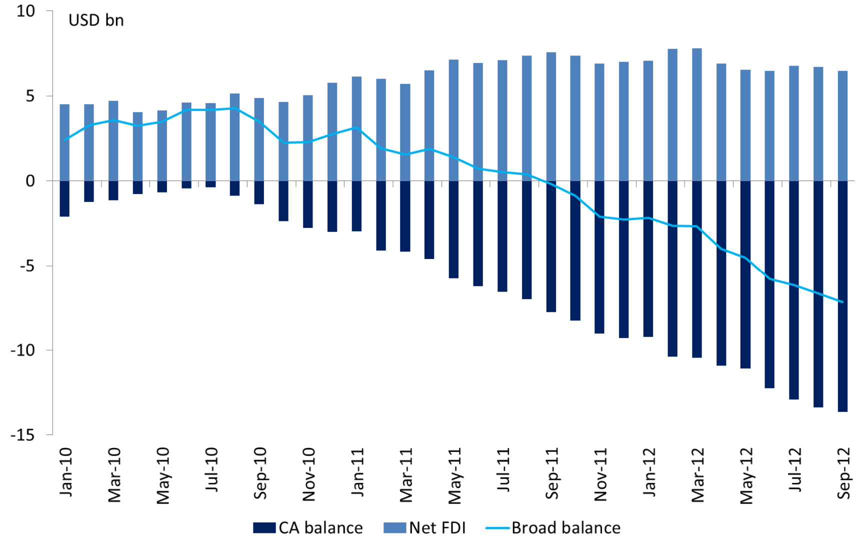
Source: AYA securities, Reuters

Liquidity conditions and thus interbank interest rates are extremely volatile as a result, mirroring depreciation pressures, and reaching more than 40% p.a. recently, after being below 5% in the first half of 2011. Ukraine shows one of the highest and most volatile interest rates in the world.

A reason for the pressure on the FX market is the continuous deterioration in external accounts, specifically in the current account deficit, as Figure 4 shows:

Figure 4

Dynamics of external accounts



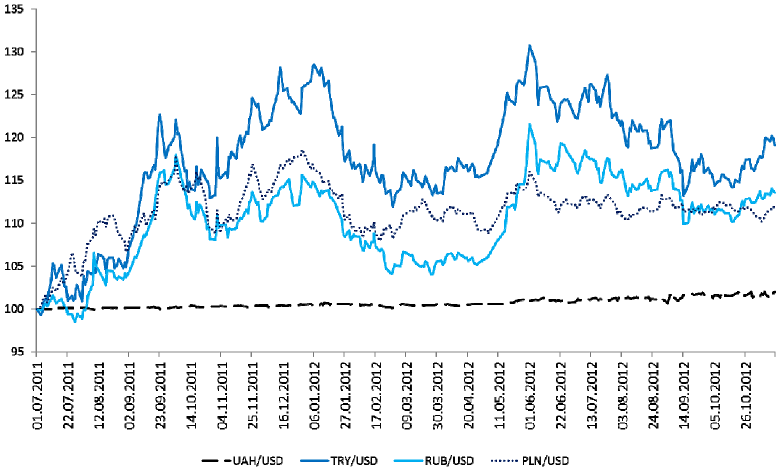
Source: NBU, own calculations

The full-year current account deficit is expected to be at USD 12.9 bn (7.2% of GDP) in 2012, after USD 10.2 bn (6.2% of GDP) in the previous year. The lackluster performance of net FDI inflows, which did not keep pace, implies that the broad balance (CA balance minus net FDI) is clearly in negative territory and further deteriorating.

The tight peg to the appreciating USD has most probably contributed to these negative developments, as many other currencies in the region have weakened significantly, as Figure 5 shows:

Figure 5

Nominal exchange rates vs. USD (indexed)



Source: own calculations based on ECB data

Apart from supporting the national currency by selling FX reserves, the authorities in Ukraine have undertaken (and are further planning to undertake) a variety of prudential and administrative measures to dampen FX demand and increase supply. These measures were targeted at different segments of the FX market, and include the following:

- Export surrender requirement of 50% of export proceeds (in place for 6 months, starting 19 November 2012). Proceeds must be sold one day after arrival in Ukraine (NBU Resolution 479)
- Repatriation of export proceeds into Ukraine cut to 90 days (from 180 days), (NBU Resolution 475)
- Monthly cross-border FX transfers above 150,000 UAH must be converted into UAH
- Decrease in net open long FX positions at banks
- Passport identification at exchange offices
- Use of only one bank for imports
- Formation of reserves for FX loans only in Hryvnia (NBU Resolution 109)
- Protectionist initiatives like increases in customs tariffs to bound rates, request under Art XXVIII GATT to review bound rates, and a draft law (approved in first reading) on a utilization fee on cars
- Planned taxation on FX cash transactions (15% pension fund duty on FX sale); draft law currently withdrawn

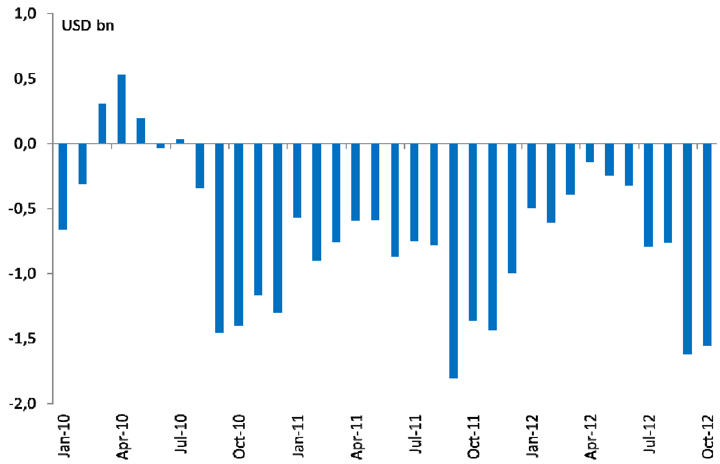
Summing above analysis up, there are clear signs that the current level of the exchange rate is not sustainable. This conclusion is corroborated by fundamental analysis as well as prevailing strong depreciation expectations by different market participants, as clearly shown by different indicators.

In terms of fundamental assessment, our own estimates from late 2011 showed that the equilibrium value of the Hryvnia should be around 5-15% weaker[1]. This signals not a huge overvaluation, but is rather in line with the other indicators shown above. Different indicators signal also persistent depreciation expectations by market participants. Non-deliverable forwards (NDF) signal an exchange rate of 8.83 UAH/USD three months ahead, and 10.35 UAH/USD one-year ahead. Surveys by professional market analysts show a similar tendency towards a weaker currency. In the last month, the median forecast for end-2012 was 8.40 UAH/USD while for end-2013 it amounted to 9.00 UAH/USD.

Lastly, if we proxy the exchange rate expectations of the population by their respective FX net demand on the cash market, we see similar prevailing tendencies:

Figure 6

Net demand for cash FX by population



Source: NBU

[1] These results are in line with recently published IMF data (Country Report 12/315, 2012), which show an overvaluation by 8%-13% using similar methods.

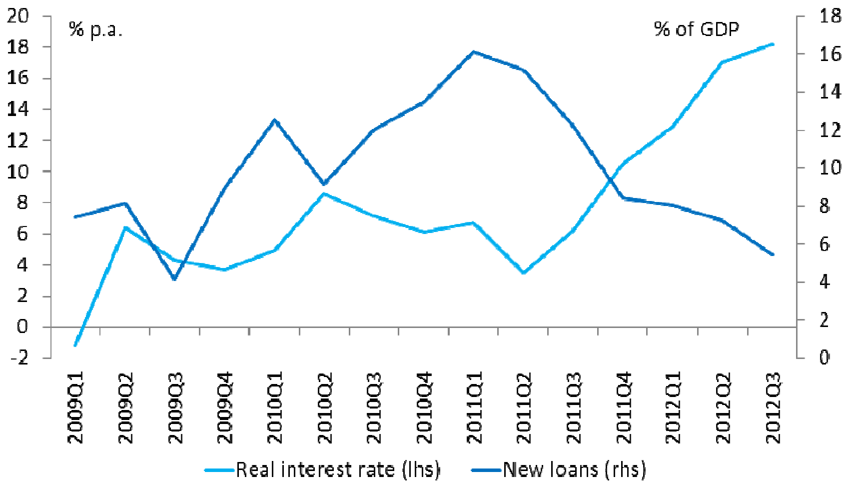
2.3 Negative impact on economic growth

To maintain a fixed level of the exchange rate despite persistent depreciation pressures comes at high cost for the economy. This should be considered by policy makers when evaluating the pros and cons of a possible regime change.

An overvalued exchange rate boosts imports while decreasing exports and thus negatively impacts economic growth. On top of that, imports get an additional stimulus by wide-spread depreciation expectations, as people hurry to purchase foreign goods before they become more expensive. The high interest rates that a restrictive monetary policy stance brings about imply lower lending by commercial banks (Figure 7). In consequence, less investment and lower economic growth both in the short and in the long run will be recorded.

Figure 7

Bank lending rates and new loans



Source: Own calculations based on NBU data

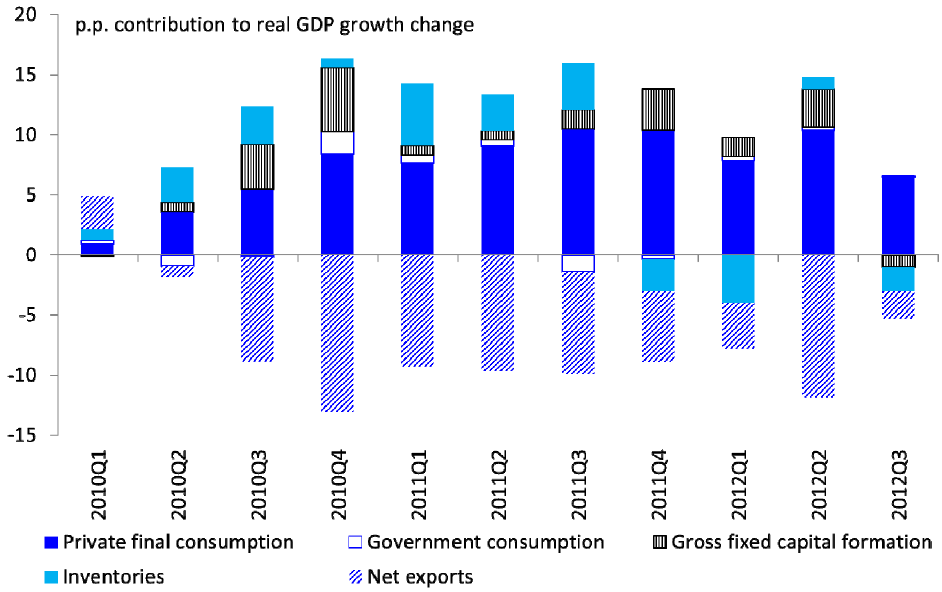
Note: Real interest rate is derived from nominal interest rate on loans to nonfinancial corporations in national currency with maturity of 1-5 years and ex-post inflation, new loans are issued over the quarter as % of GDP

This problem is particularly severe for those enterprises that have no access to international financial markets, i.e. for SMEs. Thus, there are also negative structural effects associated with the current FX policy. The prevailing depreciation expectations (see section above) are also not supportive for investments from another point of view. For many investors, the alternative is to wait for lower asset prices after the expected devaluation, and only afterwards to consider investments.

There is some empirical evidence for the damaging effects of the current FX policy in national account data. Ukraine recorded a negative growth of 1.3% yoy in Q3-2012, a situation that is not to change soon. For the full year, a stagnation of economic activity cannot be excluded. An important reason for this is of course the weak external environment and the corresponding lower demand for Ukrainian export goods (e.g. metals). However, also the FX policy and the associated restrictive monetary policy are an important reason for the current slowdown. While next exports delivered negative growth contributions for more than 10 quarters, also investments (gross fixed capital formation) are now dragging down economic growth.

Figure 8

Real economic growth: decomposition of demand side



Source: Statistical Service of Ukraine, own calculations

Conclusion 1: There is ample evidence that the current de-facto peg to the USD is not sustainable. This policy hurts economic growth at a time of increasing external headwinds. Thus, there is a desperate need to change FX policy.

3. Proposals on how to change FX policy

As explained above, there is a clear and rather urgent necessity to reform exchange rate policy in Ukraine. But what exactly has to be changed? In our view two things: the exchange rate level <u>and</u> the exchange rate system. Why? A new system based on the current overvalued currency is doomed to fail, since the existing exchange rate level cannot be maintained for long. But also a mere devaluation without any change in the system is not feasible. The existing fixed system has led to today's problems and there is no reason to assume that the same problems will not reappear in the future. For quite some time, most international economists and advisors (including the German Advisory Group) were critical of the fixed system. Ukraine's foreign trade is mainly based on commodities, whose prices are very volatile. On top comes a difficult situation on international capital markets, with the correspondent volatility of international capital flows. The existence of such vulnerabilities and risks on both the current and the financial accounts clearly calls for a strong shock absorber, i.e. for a flexible exchange rate[2].

Regarding the sequencing of changes, both moves should be done simultaneously, i.e. they should be part of one general overhaul of exchange rate policy. Regarding external communication, the two changes should form part of one big story to be clearly told to the public and population.

Despite the need for simultaneous changes, the topics should be separated for the purpose of analysis and for avoiding mixing up both aspects. Consequently, we will look first at the need to adjust the level of the exchange and afterwards discuss the design of the future exchange rate system.

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[2] The history of failed pegs in 1998 and 2008 underline this statement.

3.1 How the adjust the level of the exchange rate

From a fundamental point of view, the need for adjustment is significant, but not huge. Most experts assess the overvaluation of the Hryvnia at 20% or less. In principle, the necessary adjustment could be conducted in two different ways: gradual or sudden devaluation. Thus, the question is which of these options is viable or preferable under current conditions.

Taking a look at official FX reserves brings much light into this question. NBU FX reserves have been in steep decline since August 2011. Import coverage went down from 5 months in August 2011 to currently only 3 months, a level considered to be critical. Furthermore, the authorities need to repay foreign currency debt amounting to USD 8.9 bn next year, including USD 5.7 bn to the IMF, in midst of an uncertain access to international capital markets.

In case of a gradual devaluation, the current process of "bleeding" reserves would continue and the NBU would end up with a very low level of reserves. However, the NBU needs sufficient FX reserves in general and in particular for the establishment of a new exchange rate system (see 3.2). Any new system needs sufficient "fire power" to potentially intervene in the FX market in case of overshooting or of similar developments. Without this buffer, the new system will lack credibility and its likelihood of success will be very limited. Consequently, a gradual devaluation would extremely complicate the establishment of the new system. Since the NBU needs to change both the level and the system at the same time, a gradual devaluation is not feasible.

Gradual devaluations, as the one conducted in the Russian Federation in 2008/2009, do have some important positive features. The shock to economic agents is spread over many months and agents have more time to adapt. A gradual devaluation also softens the negative impact of balance sheet shocks; an important feature for the stability of commercial banks in high dollarized economies. Thus, gradual devaluations are certainly not per se the wrong way to adjust. However, this path can only be followed if the country has enough FX reserves to spend. In the case of Russia, the country had USD 556 bn, equivalent to 25 months of import coverage, when the gradual devaluation process started in the last quarter of 2008. But the situation in Ukraine is altogether different. FX reserves are already at a critical level, devaluation expectations are huge, high external payments lay ahead and the country needs to establish a new, credible exchange rate system. Under such circumstances there is no real choice between gradual and sudden devaluation. The only sensible way is a sudden devaluation.

A further issue to be discussed in this context is the role of administrative measures. Would it not make sense to artificially reduce demand for FX and increase supply of FX, in order to secure a gradual devaluation or even to significantly reduce the necessary size of the devaluation? Administrative measures imply very high cost to economic agents, including companies, public sector and population. Furthermore, they reduce credibility in the authorities and thus make it difficult to implement government policy. On top, administrative measures generate an industry for avoiding regulation, including black markets for foreign currency and other more sophisticated schemes, which might help individuals, but certainly not society as a whole. This makes their effectiveness apart from short-term considerations very doubtful[3]. The result of this would be, as clearly shown by international experience, an economy which is unable to attract investment and completely lacks dynamism. Instead of allocating resources into productive activities, agents are mostly concerned on how to circumvent government regulation. This is hardly the recipe for the future of Ukraine.

Recent developments in Ukraine regarding administrative measures are of great concern. Since November 2012, companies have to bring their export revenues into the country within 90 days, and convert 50% of them into Hryvnia. But even more worrying are plans

[3] This is clearly supported by the case of Belarus in 2011, when authorities tried to combat an (economically justified) devaluation by imposing administrative measures. After some months of muddling through, the authorities were finally forced to let the currency float. The economic costs of this strategy and the blow to credibility were enormous.

to tax the sale of foreign currency by the population with 15% and the purchase of foreign currency with 1%. Such measures destroy confidence in the authorities. One of the biggest economic problems of Ukraine is its poor investment climate. Such measures further deteriorate the investment climate and even discussing them is very harmful.

Conclusion 2: Ukraine needs a sudden devaluation of its currency. Administrative measures should not be implemented, since they worsen the general economic situation of the country.

3.2 How to reform the exchange rate system

The NBU has decided to move towards inflation targeting in the medium term, a decision which we fully support. However, the country is not ready for inflation targeting in the short term. Thus, there is a need for establishing a transitory exchange rate system for the next few years, which will pave the way towards full-fledged inflation targeting.

In our view, the new transitory exchange rate system has to contain the following features:

- An appropriate anchor for providing monetary stability
- Sufficient flexibility for absorbing economic shocks

Furthermore, the new system should provide incentives for the development of markets, institutions and instruments, which are necessary for the introduction of inflation targeting in the medium term.

The choice of an appropriate anchor

The US dollar (USD) is not an appropriate anchor for Ukraine anymore. The USD is still important for Ukraine's foreign trade, but so are the Euro (EUR) and the Russian Ruble (RUB). Because of significant cross currency volatility between the USD and EUR/RUB, by targeting the USD alone Ukraine can experience a strong effective appreciation or depreciation of its currency, with the corresponding negative effects. This argument is especially valid for a commodity-dependent economy like Ukraine in times of international instability and high cross currency volatilities.

At the same time, targeting an inflation index (i.e. introducing inflation targeting) is not feasible in the short term. The necessary instruments of monetary policy still need to be developed, the monetary transmission mechanism strengthened and headline inflation is likely to become rather volatile in the short term, partly due to the necessary devaluation ("pass through"), but also because of the required adjustment of administered prices in the energy sector.

Under such conditions we propose to target a currency basket, consisting of USD, EUR and RUB, with each currency having the same weight of 1/3 in the basket. The proposed weighting roughly corresponds to the trade pattern of Ukraine and is very simple to grasp and understand. A currency basket provides some flexibility in case of cross currency volatility, while not losing its primary function of anchoring monetary policy. Furthermore, since there is no fixing to any single currency, the UAH will have some volatility vis-à-vis all important currencies. This in turn will provide incentives for the development of FX hedging instruments, an important precondition for the establishment of inflation targeting later on.

Russia followed a similar path by successfully introducing a USD-EUR currency basket in 2005[4]. While keeping the parity to the basket rather fixed until the global financial crisis in 2008 and the subsequent devaluation, it used this anchor for its gradual flexibilisation of exchange rate policy afterwards. The introduction of inflation targeting is expected for 2014. Also Belarus has some experience with a currency basket, which was introduced in

[4] In the case of Russia, the relative weights of EUR and USD in the currency basket were not constant, but were adjusted from time to time.

early 2009, consisting of USD, EUR and RUB with identical weights. Thus, there is enough international experience to emulate and no need to start from zero.

How to provide sufficient flexibility

Ukraine is an open economy and its foreign trade is heavily dominated by commodities. On the export side, metals and chemicals dominate with corresponding shares of 28% and 8% in total exports. On the import side, energy plays the major role, amounting for roughly 32% of total imports. Since international commodity prices are very volatile, sudden changes in the terms of trade of Ukraine are common. Consequently, the exchange rate system in place needs sufficient flexibility to reduce the impact of such terms of trade shocks. But flexibility is also needed in light of very volatile international capital markets ("Euro crisis" in the EU and "fiscal cliff" in the USA) and the uncertain global growth outlook. More flexibility will also lead to a better pricing and management of currency risks, and contribute to less dollarization in the medium term.

Apart from targeting a currency basket, which implies already more flexibility towards individual currencies, and important way to secure additional flexibility is the use of a band around the basket. In our view the band should be rather wide.

Conclusion 3: For a transition period of a few years, until full-fledged inflation targeting is in place, we recommend the introduction of a currency basket system, as this provides the right balance between flexibility and anchoring policy and expectations.

3.3 Putting the pieces together

Let's now put all recommendations together. First, the NBU should stop intervening in the FX market and let the exchange rate find a new level. This search for equilibrium implies that any administrative measures that currently distort FX supply/demand decisions are to be scrapped. After an appropriate level has been found, the new exchange rate system should be established, consisting of a USD/EUR/RUB currency basket with a relatively wide band of say +/- 10%.

As a rule, the NBU should not intervene within the band, but at the band's limit. However, when large FX transactions take place, such as the issuing or the repayment of Eurobonds, interventions resp. off-market agreements will be certainly necessary.

The new system will allow the NBU to gradually re-orient its day to day monetary policy towards domestic objectives like securing price stability, and relieve if from the current burden to support an overvalued exchange rate. This should be a major advance in the process of building up credibility in the conduct of monetary policy. At the same time, the system provides an important anchoring function for the expectations of economic agents, and it also shields the NBU against possible political interference. Consequently, we recommend communicating to the public clearly and transparently the establishment of the new system and to highlight its advantages vis-à-vis the former peg to the US dollar.

Conclusion 4: It is important to let the market find the new equilibrium exchange rate, undistorted of prevailing administrative restrictions. This equilibrium rate would then form the basis for a currency basket system with a wide band.

3.4 Preventing possible overshooting

It is well know from theory and practise that exchange rates may overshoot their equilibrium values once they are floated. An overshooting might take place during the very first step of the plan, i.e. when the NBU stops intervening in the FX market and leaves the market find the new equilibrium. In order to prevent economic damage from a sudden and excessive jump in the exchange rate, the NBU should plan on how to deal with a possible overshooting. In our view, the NBU should internally define a minimum level of the exchange rate, which serves as a "pain threshold", and which is above what is considered the (fundamental) equilibrium exchange rate. Once this level is reached, it should cause a strong response by the NBU (i.e. interventions), as its impact on balance sheets of economic agents, especially banks, might lead to disastrous financial and economic consequence[5].

In order to illustrate this point, let's assume that the minimum internal level set by the NBU is 10.00 UAH/USD. Once the NBU stops intervening, the market might find equilibrium at e.g. 9.50 UAH/USD. In such a case, this should be taken as the central level for the new system. But it might also happen that the exchange rate overshoots and drops beyond e.g. 10.00 UAH/USD. In such a case, this should cause interventions, as this level poses threats to financial and economic stability. Once the pressure subsides, and there are no reasons to believe that the market will not be able to finally find the fundamentally justified equilibrium rate, the NBU should establish the basket system.

Conclusion 5: In order to avoid a potentially destabilizing overshooting of the currency, the NBU should internally define a minimum level of the exchange, whose crossing would cause FX interventions.

4. Final remarks

The analysis presented has forcefully demonstrated that the current FX policy in Ukraine is not sustainable, and has negative implications for economic growth. Thus, there is an urgent need for a change, along the recommendations proposed in chapter 3.

At the same time, the case of FX policy should not be considered in isolation from the overall macroeconomic policy mix in the country. Specifically, a new policy mix is needed, as the old model of a fixed exchange rate, restrictive monetary policy, and a rather loose fiscal policy failed to provide a sustainable economic development in the presence of an adverse external environment.

How should such a new policy mix look like? Apart from the increased exchange rate flexibility that we favour, and the accompanying shift in monetary policy orientation towards domestic objectives (i.e. price stability), this includes tightening the fiscal policy stance of the country. The process of fiscal consolidation, which has started after the financial crisis and delivered some positive results, was threatened by a number of developments during 2012. The election campaign caused a significant increase in a number of current spending items, which put the budget this year (but also in future years) under pressure. From a structural point of view, the quasi-fiscal deficit of Naftogaz must be tackled by increasing gas and heating tariffs, in order to put government finances on a sustainable path. A positive side effect of such tariff reform for the FX market would be the associated decrease in gas consumption, and hence less imports.

Consequently, the process of FX flexibilisation must be seen as one crucial element in a wider reform package that restores economic growth and macroeconomic stability. Therefore, this is not just a task for the NBU, but for all responsible authorities in the country.

We strongly recommend conducting the proposed macroeconomic adjustment within the framework of a new IMF program. The IMF loan would help to prepare for this adjustment in an orderly manner, and it would ultimately lower risk premiums and thus funding costs. The cooperation would also provide an important external anchor for structural reforms, and restore policy credibility.

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[5] It should be kept in mind that the banking system has an overall economic net short position of around USD 8 bn, which makes it vulnerable to depreciation. Any fall in the exchange rate would thus hit the capital of banks immediately, apart from any second round effects due to still significant FX loan books and the likely problems in servicing them for many clients.

List of recent Policy Papers

- Improving the Framework of Credit Bureaus' Operations: Key Recommendations, by Robert Kirchner, Ricardo Giucci and Vitaliy Kravchuk, Policy Paper 04, May 2012
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